



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
ALUM ROCK DEVELOPMENT COMPANY }

Appearances:

For Appellant: Herbert F. Baker, Certified Public Accountant

For Respondent: Crawford H. Thomas, Associate Tax Counsel

OP IN I ON

This appeal by Alum Rock Development Company is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying Appellant's protests against proposed assessments of additional franchise taxes in the amount of \$751.49 for the income and taxable year ended March 31, 1947, and in the amount of \$728.62 for the income year ended March 31, 1947, and taxable year ended March 31, 1948,

In 1946 a group of people entered into a business venture which involved the construction and sale of houses, The Appellant was incorporated on April 17, 1946, to acquire the real property which would be needed in this project, The J. D. O'Connor Construction Company was to build the houses, and the San Jose Building Company was to market the improved property.

The Appellant acquired land and, on May 31, 1946, sold sixty lots to San Jose Building Company for \$60,000. San Jose Building Company, in return, paid \$21,000 cash to a bank which had previously made a loan upon the property to Appellant and gave Appellant interest bearing promissory notes for the remainder of the purchase price, \$39,000. On July 27, 1946, Appellant transferred additional lots to San Jose Building Company for \$20,000, Thus the total price of lots sold to San Jose Building Company in Appellant's income year ended March 31, 1947, was \$80,000.

Soon after the sales were completed and before the end of 1946, the various parties to the business venture became involved in substantial disagreements. It appeared for a time that legal action would be necessary to determine the dispute. However, negotiations were undertaken to settle the matter outside of court. Appellant, which had adopted a fiscal year ended March 31, states that before March 31, 1947, it was apparent that the full purchase price of the lots would not be paid. Negotiations continued after March 31, 1947, and were finally ended by

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an agreement reached on August 13, 1947. The agreement provided, among other things, that the price of the lots sold by Appellant to San Jose Building Company would be reduced to \$55,683. The reduction in the amount of \$24,317 was to be credited on the notes held by Appellant. The agreement did not mention interest accrued on the notes.

Appellant filed its franchise tax return for its income year ended March 31, 1947, on August 15, 1947, after obtaining permission to file subsequent to the due date, June 15, 1947. Appellant kept its books and reported its franchise tax on the accrual method.

In its franchise tax return for the income year ended March 31, 1947, Appellant reported gross income from the sale of lots as \$55,683, thus excluding from income in that year the difference between the price reached by the agreement of August 13, 1947, and the total price of the lots at the time of the sales to San Jose Building Company, Appellant did not report as income the accrued interest on the notes, an amount of \$2,211.48.

The Respondent proposed additional assessments for Appellant's income year ended March 31, 1947, on the grounds that the amount of the price reduction and the amount of the accrued interest on the notes should have been included in Appellant's gross income for that year. Appellant protested this action of the Respondent and in the alternative claimed that bad debt deductions should be allowed in the amounts of \$24,317 and \$2,211.48 in its income year ended March 31, 1947. In support of its contention that a bad debt deduction should be allowed, the Appellant on September 10, 1952, filed an amended return setting forth the deduction as claimed.

Appellant contends that the amount of the reduction of the purchase price of the land and the amount of the accrued interest on the notes were properly excluded from gross income in the income year ended March 31, 1947. The reasons advanced by Appellant in support of this position are (1), that the amounts of these items were never actually received by Appellant, and (2), that because of the dispute between Appellant and San Jose Building Company, the Appellant knew before the end of its fiscal year that the sales price would never be paid in full.

Appellant may not sustain its objection to the inclusion in gross income of the full sales price of the land and the accrued interest on the notes on the grounds that the income was never actually received. Section 24631 of the Revenue and Taxation Code requires that income shall be computed on the basis of the taxpayer's income year. Section 24651 requires that the computation shall be made "under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books." (These provisions were contained in the former Bank and Corporation Franchise Tax Act, Section 12.) Where an accrual-basis taxpayer rescinds a sale or reduces the purchase price of a sale in a year subsequent to that in which the income from the sale is accruable, the taxpayer may not reduce the amount of the accrued income

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in the earlier year, The proper adjustment is made by taking a deduction in the later year, if any deduction is allowable. Jacob Care, 31 B.T.A. 541. Where a note is taken by an accrual-basis taxpayer with the expectancy of ultimately receiving full payment on it, the full amount of the note is accruable as income in the year in which the note is taken. Fisher Brown, T. C. Memo. Dkt. No. 23799 (November 20, 1950).

Where a taxpayer keeps his books on a accrual basis, it is the right to receive and not the actual receipt which places the amount in gross income, In such case he is required to treat the amount as gross income in the year in which the right to receive the income arises. Spring City Foundry Company v. Commissioner, 292 U. S. 182, 78 L. Ed. 1200, This principle applies to income arising from the sale of land. Frost Lumber Industries v. Commissioner, 128 Fed. 2d 693.

Appellant urges, however, that the income in the present case was not accruable in its income year ended March 31, 1947, because there was a dispute in progress at the end of the fiscal year between the parties to the sale and because it was clear at the end of the fiscal year that the purchase price would never be paid in full. Appellant cites no authority in support of its position, That there may have been a controversy in progress at the end of the taxable year does not mean that Appellant's right to receive the full purchase price was impaired. On the facts of this case, we may not even assume that the Appellant's right to receive the full purchase price of the land was the subject matter of the dispute. Furthermore, even in a situation where the purchase price of land is left to later computation, and a dispute arises as to the method of making the computation, for tax purposes the sale is treated as concluded on the date of the sales agreement even though a settlement by compromise follows the dispute. Frost Lumber Industries v. Commissioner, *supra*.

Under some circumstances a taxpayer is not required to accrue income which it knows to be uncollectible. Corn Exchange Bank v. U. S., 37 Fed. 2d 34; American Central Utilities Co., 36 B.T.A. 688. But there is nothing in the facts of this case to support an argument that the debt was uncollectible at the end of the fiscal year, or at any time previous to the settlement of August 13, 1947. Hence, we conclude that because Appellant had the right to enforce a collectible debt at the end of its fiscal year, the full purchase price of the land, plus the accrued interest on the notes, was accruable in the income year ended March 31, 1947.

Appellant takes the alternative position that it is entitled to a bad debt deduction for the income year in question, However, there is no evidence that the debt owed Appellant by San Jose Building Company was ever partially worthless. Certainly it was not wholly worthless. It is too late for the Appellant to claim a deduction for a partial bad debt because no part of the claimed deduction was charged off on Appellant's books during the income year. Section 24348 of the Revenue and Taxation Code provides in part:

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"...When satisfied that a debt is recoverable in part only the Franchise Tax Board may allow such debt, in an amount not in excess of the part charged off within the income year, as a deduction,..."
(Emphasis added.)

Except for a **reference** to the commissioner instead of the Franchise Tax Board, this was the language of former Bank and Corporation Franchise Tax Act, Section 6(e). In addition to the foregoing, Title 18, California Administrative Code, Section 24121 f(1)(b) provides:

"Before a taxpayer may deduct a debt in part, it must be able to **demonstrate** to the **Francise** Tax Board the amount thereof which is uncollectible and the part thereof which was charged off."

The language of the statute and the regulation is so clear that we cannot accord any validity to Appellant's contention on this point.

The Appellant also requests that it be allowed to make an addition to a reserve for bad debts, if the amounts in question are to be **includible** in gross income for the year in question. There is even less justification for this claim, because not only did the Appellant not make an addition for this purpose to a bad debt reserve during the income year, but also it did not maintain a **reserve** account, Title 18, California Administrative Code, Section 24121 f(4) allows as a deduction from gross income a reasonable addition to a reserve for bad debts in lieu of a deduction for **specific** bad debt items, but this is for "Tax-payers who have **established** the reserve method of treating bad debts and **maintained** proper reserve accounts for bad debts" (Emphasis added.) The amended return filed in 1952 could not accomplish for Appellant what it did not do in the income year ended March 31, 1947.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Alum Rock Development Company to a proposed assessment of additional franchise tax in the amount of \$751.49 for the income and taxable year ended March 31, 1947, and in the amount of \$728.62 for the income year ended March 31, 1947, taxable year ended March 31, 1948, be and the same is hereby sustained.

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Done at San Francisco, California, this 29th day of December, 1958,
by the State Board of Equalization,

George R. Reilly , Chairman

Robert E. McDavid , Member

Paul R. Leake , Member

J. H. Quinn , Member

Robert C. Kirkwood , Member

ATTEST: Dixwell L. Picrcc , Secretary